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Update on Oil & Gas Law: Recent Development in Natural Resource Law - 2007

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OIL & GAS LAW

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Recent Developments in Natural Resources Law - 2007
By Thomas A. Daily[1]

It has been an eventful year. There is much to tell. Lets get started.

Arkansas Court of Appeals Reverses Summary Judgment Voiding Mineral Quiet Title Decree

John and Darla Verkamp's predecessors secured a quiet title decree to both surface and minerals in 1976. The decree was obtained by default, upon constructive service. The only factual basis stated for the decree was adverse possession which, as to minerals, was provably false.[2] Sonat Exploration Company, the predecessor of XTO Energy Inc., obtained an oil and gas lease from the Verkamps[3] and integrated the interest of the prior severed mineral owner. At XTO's request, Floyd E. Sagley Properties, LTD, the unit operator, suspended royalties on the interest.

The Verkamps sued Sagely and XTO, relying upon the 1976 decree. XTO and Sagely moved for summary judgment that the 1976 decree was void as to the severed mineral interest. In support of the motion, they attached a title opinion prepared by J. H. Evans, who had opined that the decree was likely subject to collateral attack for lack of notice, and was based upon provably false alleged facts. The circuit court granted summary judgment to Sagely and XTO.

[1] Member, Daily & Woods, P.L.L.C., Fort Smith, Arkansas

[2] As we all know, you can only adversely possess against a severed mineral owner by actually producing the minerals. That had not happened.

[3] Purely for protection.

The Court of Appeals reversed and remanded.[4] The court said that Mr. Evans' opinion, which was unsworn, could not support the summary judgment and that Sagely and XTO had offered no proof that the severed mineral owners could have been notified of the 1976 proceedings even if reasonable diligence had been exercised.

The Court of Appeals instructed that if Sagely and XTO sought to be protected from potential double exposure, they should have interpleaded the royalties from the well and added the severed mineral owners to the suit.

SUPREME COURT REAFFIRMS ITS PRIOR RULING IN *SMITH V. AJ&K CASE*

One of my favorite recent decisions of the Arkansas Supreme Court is its case of *AJ&K Operating Co. v. Smith.*[5] Remember? That was the case where the landowners contended that the oil companies had contaminated their land, but did not want the land cleaned up, because that would have messed up their lawsuit against the oil companies. The Supreme Court reversed an injunction barring the cleanup. The Court held that cleanup was the preferred remedy for the landowners and was in the interest of the state and its regulatory agencies.

[4] *Verkamp v. Sagely*, ____ Ark. App. ____, ____ S.W.3d ____ (2006).

[5] 355 Ark. 510, 140 S.W.3d 475 (2005).

Well, the landowners were persistent. When the circuit judge, who was wrong to enjoin cleanup the first time, lifted his injunction so that cleanup could occur, the landowners appealed that order. The Supreme Court wasted little time on this one, making clear that it meant what it had already said.[6]

ARKANSAS SUPREME COURT AFFIRMS JURISDICTION OF A.O.G.C. OVER CERTAIN JOA DISPUTES

Great Lakes Chemical Corporation operates three brine units in Union County. Albemarle Corporation has similar brine operations in Columbia County but has, at least for the present, avoided forming units. Both companies process the brine to extract elemental bromine, some of which they sell, but most of which they incorporate into other chemical products.

Great Lakes formed its units in 1995 and 1996 under the provisions of the Arkansas Brine Conservation Act[7] when it was being sued by unleased mineral owners of lands near its facilities, who claimed mineral trespass resultant from the water flood nature of the brine production operations.

The unitization statute requires the applicant to present a plan of operations with estimates of costs and revenues from brine production. At the time its unitization applications were presented, Great Lakes had a rather primitive cost accounting system. It tracked costs from major expense categories, but allocated those costs based only upon estimated percentages. When it came time to allocate estimated costs between the brine units and those Great Lakes facilities, such as pipelines and processing plants, which were not part of the units, a lot of percentage allocation took place. Some of that

[6] *Smith v. AJ& K Operating Company*, _____ Ark. _____, _____ S.W.2d _____ (2006).

[7] A.C.A. §15-76-301 et. seq.

was pretty wrong.

Albemarle obtained a major brine lease within Great Lakes West Plant Unit from Murphy Oil Corporation, as well as a number of other leases from smaller companies. Murphy had previously elected to participate under the A.O.G.C.'s unitization order, so the interest was subject to the unit operating agreement approved by the A.O.G.C. At first, Albemarle resold its proportionate share of brine to Great Lakes but, ultimately, it built a bromine plant and began taking brine in kind.

Meanwhile, Great Lakes updated its cost accounting system, world wide, installing industry standard SAP accounting. Neither Albemarle nor the A.O.G.C. were asked, or even told, about the change. The result of SAP was better, more accurate, cost accounting, but it resulted in higher joint interest bills to Albemarle and other unit participants.

Albemarle filed an application before the A.O.G.C. seeking an order directing Great Lakes to revert to its prior accounting methodology. Ultimately the A.O.G.C. granted Albemarle's application, overruling Great Lakes' challenges to its exercise of jurisdiction over a COPAS dispute. Both the circuit court of Union County and the Arkansas Supreme Court affirmed the A.O.G.C.[8]

[8] *Great Lakes v. Bruner,* ____ Ark. _____, _____ S.W.3d _____ (2006).

The significance of this decision to the oil and gas industry is, as yet, undetermined. It may be great. Virtually every gas well is drilled after the operator secures an integration order. That order routinely incorporates an operating agreement. Indeed, the A.O.G.C. has taken the seminal step of dictating a standard form operating agreement. Under the logic of the *Great Lakes* decision, any participant who elects to participate under the A.O.G.C.'s integration order may request the A.O.G.C. to then interpret and enforce the operating agreement, rather than litigating a JOA dispute in court.

The A.O.G.C. is not a court. At any given time one, maybe two of its members will have attended law school. Contract interpretation is traditionally a matter of law, decided by the court as such and not submitted to a jury. Such decisions are then reviewed by an appellate court *de novo*. However, the administrative process is different. The agency is virtually presumed right. Distinctions between law and fact are blurred. Watch out folks. This is one slippery slope.

CONFUSING SEISMIC TRESPASS CASE HEADED FOR ARKANSAS SUPREME COURT

You have heard the term "runaway jury", right? Well then, how do you feel about a runaway judge. We are not talking about a jurist who failed to show up for court, either. *El Paso Exploration Company v. Blanchard*[9] is an example of a runaway judge who stayed in the courtroom. As they say, however, "bad facts make bad law," and this case has enough bad facts to repeal the ten commandments.

It all started when the A.O.G.C. enacted something called General Rule B-42,

[9] Columbia County, Arkansas Circuit Court Case No. E-98-212-5, consolidated with No. CIV-98-137-5, currently docketed on appeal as Case No. CA-06-1107.

regulating seismic exploration. That rule, as originally enacted,[10] provided:

> No entry shall be made by the permitee upon the lands upon which such seismic operations are to be conducted without the permitee having first secured a permit from the **landowner** authorizing such operation to be conducted. (emphasis added)

[10] The rule has since been amended to remove the problem which started the judge running in *Blanchard.*

James Blanchard is clearly a "landowner." He owns the surface and a one-half mineral interest under the tract involved in the litigation. Blanchard gave an oil and gas lease to a company named Swift Energy Company. That lease authorized, among other things, exclusive geophysical operations. The lease also prohibited assignment without Blanchard's consent.[11]

The other one-half mineral interest was leased to El Paso's predecessor, Sonat. That lease also authorized geophysical operations. Swift and Sonat entered into an agreement whereby each became obligated to permit certain seismic operations conducted by the other and acquired the right to purchase a license to the data. Apparently pursuant to this agreement,[12] Swift permitted Sonat to conduct seismic operations on its lease from Blanchard.

As luck would have it, Blanchard is an extremely disgruntled Sonat ex-employee. He apparently even claims to still have festering knife wounds resultant from an altercation with another Sonat employee. Under no circumstances would Blanchard permit Sonat to conduct seismic operations upon his land. When Sonat's contractor approached him for a permit, Blanchard refused.

Sonat applied for and received a temporary restraining order allowing access to Blanchard's land. The seismic was conducted with very little surface damage, but, unfortunately, no promising discoveries of potential hydrocarbons.

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[11] Which could not be unreasonably withheld.

[12] There are some inferences in the briefs that Swift actually permitted Sonat to conduct operations beyond those covered in the agreement.

Meanwhile, Blanchard made a discovery of his own, A.O.G.C. General Rule B-42, and counterclaimed, alleging trespass, surface damages under the express provisions of the Swift lease and interference with contract[13] by Sonat.

After years of motions, every one of which Sonat lost, Sonat[14] lost again in a bench trial. The circuit judge held that Sonat, by not obtaining Blanchard's express permission, had violated General Rule B-42, and was thus a trespasser. He further held that Swift's purported attempt to permit Sonat's operation was precluded by the prohibition against assignment in the Swift lease. Finally, he agreed with Blanchard that Sonat had interfered with Blanchard's contract with Swift. It was then that things really went bad for Sonat.

In addition to surface damages, apparently awarded twice,[15] the circuit judge awarded Blanchard $260,000 on a strange theory of unjust enrichment. The calculation is interesting, to say the least. The circuit judge took the average AFE dry hole cost of several wells in the vicinity and subtracted the cost of the seismic line shot by Sonat. He concluded that Sonat saved $260,000 by condemning the acreage with the seismic lline, rather than by drilling a dry hole. Then, through unexplained reasoning, he awarded that savings to Blanchard as a windfall. Mercifully, the circuit judge denied Blanchard's request for punitive damages.

[13] The Swift lease.

[14] By then, El Paso.

[15] Once for breach of contract and then again for interference with the same contract. Go figure.

Sonat has appealed. This case should go straight to the Supreme Court. The resultant opinion may very well teach us the answers to a few Arkansas unknowns, such as whether a severed mineral owner may permit seismic operations against the wishes of the surface owner. It certainly ought to be reversed, at least as to the dry-hole-minus-seismic damage award. However, I remember saying that about *SEECO v. Hales,*[16] so let us wait and see.

OKLAHOMA COURT AFFIRMS MALICIOUS PROSECUTION JUDGMENT AGAINST PRODUCER WHICH OBTAINED T.R.O. ON FALSE STATEMENTS

The above discussion of *Blanchard* should cause us to wonder whether we need to keep getting those handy temporary restraining orders. Sure, T.R.O.'s are quick and easy. Post a little bond, get back to work. No notice, no nasty trial, just file the complaint, visit in the judge's office, and send the sheriff out with a court order.

That is apparently what Tidewater Petroleum Corporation had in mind when Philip and Joe Bill Lierly refused to allow Tidewater to use a road which they were constructing on their property for access to its wells, in lieu of the awkward existing lease road. In its complaint Tidewater gilded its lily a bit. It alleged, falsely, that the Lierlys had denied it access to its wells.[17] When the dust had settled Tidewater was denied its requested injunction, was sued for malicious prosecution, and was on its way to the Oklahoma Supreme Court with a loser of an appeal.[18]

ILLINOIS COURT OF APPEALS BUCKS TREND -

[16] 330 Ark. 402, 954 S.W.2d 234 (1997).

[17] Not true, there was another road in use at the time which remained available.

[18] *Tidewater Petroleum Corporation v. Lierly*, 139 P.3d 897 (Okla 2006).

HOLDS THAT COAL BED METHANE BELONGS TO COAL OWNER

There is no Arkansas decision whether, when gas and coal are separately owned, coal bed methane belongs to the gas or the coal owner. There is a split of authority nationally, with most of the recent decisions going to the gas owner. However, there are still jurisdictions, particularly eastern coal mining states, which go the other way. So went the Illinois Court of Appeals, Fifth District in the case of *Continental Resources of Illinois, Inc. v. Illinois Methane, LLC.*[19]

Coal bed methane is being developed today in Western Arkansas. Indeed, there is a currently pending interpleader action involving this very issue. The last such interpleader case was settled, but this one involves a different coal owner. If this issue ever gets to the Arkansas Supreme Court, I will bet on the gas owner, but it is not a sure thing.

TEXAS COURT OF APPEALS INTERPRETS ROYALTY RESERVATION CORRECTLY

In *Stewman Ranch, Inc. V. Double M. Ranch, Inc.,*[20] the Texas Court of Appeals interpreted the following language in a warranty deed from Stewman to Double M. Ranch:

> There is, however, excepted and reserved to the Grantors an undivided one-half (1/2) of the royalties to be paid on the production of oil, gas, and other hydrocarbons from the described lands which are presently owned by Grantors for and during the lives of Helen A. Stewman and O. T. Stewman, Jr. and, upon the death of the survivor of them, this retained royalty interest will vest in Grantee, its successors and assigns.

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[19] 364 Ill. App. 3d 691, 301 Ill Dec. 887, 847 N.E. 2d 897 (2006).

[20] 192 S.W. 3d 808 (Tex. App. Dist 11 2006).

The deed also excepted prior mineral reservations, thus obviating any *Duhig* issue. The Stewmans contended that the phrase "which are presently owned" modified "lands," thus giving them a net reservation of one-half, regardless of the extent of prior reservations. Double M. Ranch contended, successfully, that "which are presently owned" modified "royalties to be paid" and that the Stewmans thus reserved only one-half of whatever interest they had immediately prior to the conveyance. The Appeals court agreed with that interpretation.

Had I examined this title I would have gone with the Double M. Ranch interpretation, so I am pleased with the decision.

TEXAS SUPREME COURT HOLDS THAT JOA PARTY ASSIGNING INTEREST REMAINS LIABLE FOR JIB EXPENSES

The oil and gas industry sometimes pays little attention to its contracts, instead, pretending that custom can override over express contract terms. We have seen an example of this when courts remind us that Maintanance of Uniform Interest is an express JOA provision, not subject to amendment by industry custom. Another example comes to us in the form of *Seagull Energy E&P v. Eland Energy Inc.*[21] Eland, a party to the unit JOA, assigned all of its unit interest to Nor-Tex Gas Corporation. Nor-Tex failed to pay joint interest bills from Seagull, the unit operator. Seagull sued Eland, which contended that its assignment relieved it of future liability.

The Texas Supreme Court did not agree. There is no express provision of the JOA which would convert a unilateral assignment of a party's JOA interest into a novation. The common law of contract is that an assignor remains liable for the performance by its

[21] _____ S.W.3d _____ (Tex. 2006)

assignee. Next time, Eland, assign to someone who pays its bills.

The legal analysis seems correct, though I suspect most of us would have guessed the opposite result, based upon our understanding of industry custom.

West Virginia Supreme Court of Appeals Holds "At the Well" Language Ambiguous, Disallows Charging Royalty Owners for any Post-Production Costs

Whether, and to what extent, post-production costs are proportionately changeable to royalty owners remains a chaotically uncertain issue. Modern gas marketing methods almost never involve sales at the well. However, most leases measure the royalty calculation at that place. Thus, producers, and some courts have created calculated prices "at the well" for royalty calculation purposes, by netting back costs of gathering, transportation, dehydration, compression, etc. necessary to transport the gas to market and make it saleable. Courts appear increasingly less tolerant of that practice, despite that it makes perfect sense.

In *Goff v. Columbia Natural Resources, LLC*[22] the West Virginia Court of Appeals refused to buy the "at the well" argument. That court acknowledged the split of authority nationally, but found "at the well" to be ambiguous and not a justification for netting back post-production costs. Apparently, in West Virginia, the royalty owner will get his fraction of the gross sale price of the gas, regardless of where and how sold.

Kansas Court of Appeals Holds Habendum Clause Trumps Pugh Clause

In *Schwatken v. Explorer Resources, Inc., et. all*[23] the Kansas court of appeals

[22] 219 W. Va. 266, 633 S.E.2d 22 (2006).

[23] 24 Kan. App. 2d 873, 125 P.3d 1078 (2006).

was required to interpret an oil and gas lease containing an apparent internal conflict. The lease contained a pretty typical Habendum Clause containing the language:

> If, at the expiration of the primary term of this lease, oil or gas is not being produced on the leased premises or on acreage pooled therewith, but Lessee is then engaged in drilling, reworking, or dewatering operations thereon, then this lease shall continue in force so long as dewatering or drilling operations are being continuously prosecuted...

There was also a Pugh Clause which provided:

> It is agreed that at the end of the primary term, this lease shall expire as to all lands located outside of a producing unit.

As luck would have it, the first well on the lease was commenced prior to the expiration of the primary term, but was not completed and put into production until after the primary term had expired.

The Schwatkens argued that the Pugh Clause, which they drafted, prevailed. Thus, they reasoned, they got a free well. The court held otherwise. Under the specific language of the Habendum Clause, actively conducting operations is a complete substitute for production, not only for purposes of that clause, but for the remainder of the lease, as well, including the Pugh Clause. This was a good decision. The result urged by the Schwatkens would have rendered a significant portion of the Habendum Clause of the lease meaningless and give them an unconscionable windfall.

A.O.G.C. Revises Rules and Policies

It was an active year for the Arkansas Oil and Gas Commission. With the continuation of intense development of the Fayetteville Shale play, two day integration dockets have returned. Those two day dockets would be three or four day dockets had the Commission not enacted rules and procedures to streamline the process. As an example, new General Rule B-43 obviates separate field rules for units east of Pope County. The Commission's new standardized operating agreement should save time and energy, as well, by ending arguments over individual JOA provisions[24]

Another major time saver is the Commission's amended General Rule B-40 which provides authorization for the Director of Production and Conservation to administratively approve applications for exceptional well locations (wells located closer to unit boundaries than otherwise permitted) and to impose a penalty upon the well's production allowable.

The revisions to General Rule B-40 permit administrative approval, not withstanding the extent of the penalty,[25] and have untied the administrative location process from the hearing docket, thus shortening the time required to obtain approval. Take note that there is an official application form published on the A.O.G.C.'s website. The A.O.G.C. staff takes the position that the use of this form is mandatory.

OH NO! IT IS ANOTHER LEGISLATIVE YEAR

Every other year, whether we need it or not,[26] our legislators wander out of the hills and bayous to descend upon capital city. Usually that makes for an odd year indeed.

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[24] We will not discuss General Rule B-43 or the standardized operating agreement in detail here. Each is the subject of a separate paper presented at this Institute.

[25] Previously, if the calculated penalty exceeded 50%, the application required a hearing before the full commission.

[26] I firmly side with the nots on this one.

Watch out for bills attempting to limit surface access. There is a militant group of well haters down in South Logan County who can shout with the best of them. These folks, many of whom purchased their lands knowing full well that they owned no minerals, see no good reason for oil and gas exploration. They have the ear of a few legislators who are showing some determination. The problem is that a lot more legislators do not care, one way or the other. The way deals get made in the capital, we could be in trouble.

Also expect legislative attempts to divest severed mineral owners of their property. Surface owners who own less than 100% of the minerals under their surface are powerfully jealous of their neighbors who get paid big bonuses. Indeed, this may be the year that some kind of mineral prescription bill actually becomes law.[27]

As the session has just begun, it is too soon to predict the full extent of the mischief to be expected. We will know more soon and I will report then. Stay tuned.

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[27] Some of us have actually helped draft a severed mineral abandonment bill designed to be workable and constitutional.